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TABLE OF CONTENTS

President's Page 1

The Interpretative Function 3
By A. C. Littleton

Internal Control Evaluation Methods 8
By Robert F. Dickey

The Case of Newman, Ruggles and Handley 14
By Leonard Savoie

The Role of the Senior Accountant 18
By W. D. Harris

Controllership Opportunities in Profit-Planning 24
By Maurice B. T. Davies

Tax Comments 32
Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

Present and Future Educational and Experience Requirements for Certified Public Accountants in Illinois 39
By Neil E. Clifton

Inventory Observation 44
By O. Eldred Gough

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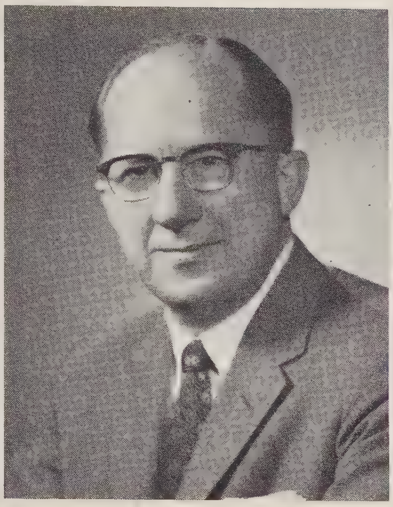
PRESIDENT'S PAGE



In connection with a project recently undertaken by the American Institute of Certified Public Accountants, an attempt was made to test public opinion and ascertain, among other concepts, the image of the accounting profession in the mind of the typical business or community leader. The results of the survey are not all flattering.

It is a temptation to think that the public's conception of the professional accountant is based upon the rather infrequent instances in which characters in novels, movies and television shows are identified as accountants or CPAs, and that the characterizations are unfair. In truth, however, it should be recognized that generally a writer will present his characters in a form which he believes will be accepted by the reading or viewing public as true to life. The members of the accounting profession are at least partially responsible for the fictional characters. If we do not like the way we are portrayed, we should take time for critical self-examination.

When considering what can be done about the public image of an "accountant," one specific suggestion is to undertake to establish a clear distinction between a Certified Public Accountant and an accountant who does not have this basis for recognition. Although business and community leaders may be aware of the fact that there is a difference between CPAs and non-CPAs, the finer aspects of the distinction are seldom fully appreciated. Further, in many instances a man may be known in his community as an "accountant" without even his friends and associates being able to state whether or not he is a CPA. To put it somewhat harshly, the status of beig a Certified Public Accountant is not universally recognized as being significant, and at times a CPA may not act as though he himself recognizes the significance.

Individually the CPA has a responsibility in conducting himself so that he will be remembered as a professional man, and there is little that a Society such as ours can do to help. For present purposes technical proficiency in whatever is undertaken (the President's Page in the last issue made reference to the "average" CPA) will be conceded, but that is not enough.

At *social functions* many professional accountants tend to avoid any show of humor and to forget they need not continue their on-duty attitude of making an audit or a critical management survey. The CPA may have to put forth more effort than other professional men to be accepted as a

fellow member of society rather than as a machine which may or may not possess normal human traits. The reading of current best sellers and being generally informed as to recent developments in world affairs, local politics, the arts and sciences will be a big help. An interest in sports is presumed, even though the presumption may not be justified.

In *community activities* the CPA should demonstrate an ability to appreciate all of the details encountered in the operation of the institutes with which he is associated. There is more to the functioning of a church, scouting, PTA, or other community organization than the solution of financial problems. The true professional man will be willing to assume responsibility in any area where help is needed.

In *business contacts* the professional man who will be remembered as an individual is not necessarily the one who has made the shrewdest suggestion at a critical moment. No business accomplishment is entirely the result of any one decision. When success is achieved, all of the participants in an undertaking will take satisfaction from what has been accomplished. The associate most respected and best remembered when the job is finished will be the individual who has consistently made contributions but has not sought ways of overshadowing or minimizing the contributions of others.

The foregoing observations might all be summarized by stating that even though the CPA be always technically proficient—that feature of his work is indispensable—the public image we are seeking will be achieved only when adequate attention has been given to personality development. The essential element in this undertaking is for each member of the profession to determine the kind of man he wants to be, and then to devote his time and energies in social, community, and business activities so as to portray his own mental image.

Raymond A. Hoffman

THE INTERPRETATIVE FUNCTION

By A. C. Littleton

There can be no question that ac-ounting data are able to serve the nterpretative needs of business. There nay be reason to doubt, however, that he accountant is an interpreter earching for meaning and significance eneath account data. It would be loser to the fact if he were considered o be an analyst who undertakes to esolve a complex into more under-tandable form.

Accounting has performed an analy-ical function throughout its centuries f use. It was initially developed to nake an enterprise more understand-ble; primarily its chief forces have een, and still are, toward enterprise nanagement. The method has been ne of classifying and compressing ata of prior enterprise experience. 'he assembled data are then organized n ways that indicate natural inter-elations and contrasts. But those ata, where compacted and communi-ated, still await interpretation. Even fter critical examination (audit) and ertification, the financial statements epresent an effort to marshal data nalytically.

Within an enterprise its factual ex-erience may be analytically organ-zed in any way that may aid man-gement in making decisions. This ame mass of basic data, however, is ot available for interpretative study utside the enterprise. It may be that this difference in data availability, during the years while professional accounting has been developing, has stimulated a desire to organize finan-cial statements in ways which could cue the reader toward interpretative consideration of various significant data relationships. Certainly modern statements, in contrast to the earlier presentations, seem to point in this direction.

Is there any limit to this kind of improved communication through financial statements? Must account-ing be continually innovated toward more analysis and interpretation? Has not one section of contemporary literature been critical of accounting realism because of a belief that ac-counting has an underdeveloped inter-pretative mission?

Pressures of Inflation

In some of the literature lies the implication that accounting has con-tributed to contemporary monetary inflation. To some a collateral belief is suggested: that reform of account-ing proceduce (with respect to in-vested-cost dollars) would influence people in authority to take steps that would mitigate the inflationary trend. On the other hand, it may be that the matter really at issue is not ac-counting's responsibility for fostering

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price inflation, but rather a question of the real value of the function of accounting and of the professional accountant.

If it were merely a matter of choosing one setting or another for defining function, this kind of choice might be thought available: (1) Accounting should be considered a classification apparatus designed to produce, by the analysis of enterprise transactions, certain arrangements of quantitative data which help make the enterprise-complex understandable. (2) Accounting methodology should be developed so far as is possible in the direction of meaningful interpretations of enterprise data appropriate to the differing needs of various users. But mere definition is not conclusive.

It is unlikely that any one belief or purpose would have motivated all the contributions to the continuing debate on common-dollar accounting. A variety of reasons can be conjectured:

(1) To help awaken the public to the seriousness of a continuing expansion of the currency and of the rise in price levels.

(2) To stimulate constructive consideration of the effects of the ideological, financial, political, and emotional pressures that foster inflation.

(3) To show that acceptance of new elements of methodology could further increase the service accounting can render the users of its data.

(4) To reveal the impact of changing price levels so forcibly that the prestige of the Internal Revenue Service and the Securities and Exchange Commission would support wide acceptance of modified accounting methodology.

Conjecture evaluating results to date might include such thoughts as the following:

(1) Direct reform in ledger account usage was not argued in the literature; although this approach was seldom ruled out, it was sometimes implied.

(2) Various types of inflation impact disclosure were suggested, the simplest being use of footnotes, the most comprehensive being use of full scale supplementary financial statements.[1]

(3) One of the simpler types of disclosure of the inflation impact upon depreciation charges has been accepted by the Securities and Exchange Commission for some recent financial statements.[2] By agreeing to certain statement amendments, the Commission has shown a disposition to accept the appropriation of net income method and to disapprove depreciation adjustments in the computation of net income.

It is clear that debate can stimulate a variety of ideas; rational judgment and satisfactory choices among alternatives can follow. Therefore, it may be reasonable to believe that this debate may have played a part (though still unmeasurable) in stimulating a public awareness, such as now seems to be growing, of the dangers of cumulative monetary inflation. It seems doubtful, however, whether many readers were impressed by implications, observable here and there in the literature, that accounting methodology as such possesses the power, through self-reform, effectively to modify an inflationary trend.

Two Techniques of Analysis

A matter less evident than the fact of a present monetary inflation also lies unperceived beneath this debate. As was indicated in earlier paragraphs, this involves the question whether two techniques—that of analytically marshalling data and that of interpreting meaning from those data

[1] The latter approach was suggested as early as 1920 by Professor W. A. Paton in *The Journal of Accountancy* for July of that year.

[2] "Price Level Depreciation in Annual Statements," *The Journal of Accountancy*, Vol. 108, No. 3, pp. 16, 18.

—have become unwisely intermixed n accounting during its significant rowth over the past fifty years.

As interest in accounting research ontinues to grow, consideration of inderlying fundamentals in addition o "postulates and conventions" vould seem very apropriate. If analsis and interpretation are basically lifferent, as seems quite likely, their ontinued intermixing seems to invite onfusion concerning the limits of the ccounting function.

Even if the two are ultimately udged separate phases of one funcion, each phase would have a distinct ontribution to make. And each hould be separately recognized; each hould become a recognized part of raining for accounting careers.

Some recent thoughts by Professor Paton appear to lend support to the dea of further consideration of interretation as a technique. Managenent may sometime find it necessary, ie writes, "to develop staffs of eco- iomic analysts who can stand between hem and their accountants and do he job of converting and interpreting he raw heterogeneous data of conven- ional reports . . . furnish certain ypes of interpretations of the underying financial data."[3]

It steadily becomes more obvious hat the mere accumulations of data n ledger accounts and the communiation of the compressed essence of ccount data (balance sheets and inome statements) are not enough. The ask still remains for management nternally and investors externally to xtract from the total data available o them such understanding of the nterprise as may help them make wise decisions regarding their respective problems.

[3] W. A. Paton, "Depreciation—Concept and leasurement," *The Journal of Accountancy*, Vol. 08, No. 4, pp. 38-43.

It is clear that accounting operates within limits; it cannot be all things to all men. Accounting is a service technology, to be sure, yet not in the sense of being able to furnish those figures that one would most like to see. A significant limitation lies in the fact that accounting must present dependable figure-symbols to the interpreter. Accounting cannot provide the symbols and at the same time penetrate the significance of the pattern made by these symbols to all interested parties.

Supplementary Interpretation

The usual financial statements are analytical patterns of symbols; they are familiar yet in need of careful interpretation. The idea of supplementary statements stated in terms of current dollars is nearly forty years old and has been studied intensely in recent years; they offer a promising interpretative adjunct to the financial statements. That so little use has been made of this device in published company reports and that no published reasons for this hesitation have appeared is puzzling.

Some part of accounting research activities might well be directed toward throwing some light on this matter of mixing the analytical marshalling of financial and operating data with the interpretative extracting of meaning from those data. Perhaps there are in fact two types of techniques here; perhaps differently trained personnel should manage each technique: people trained in business and accounting and people trained in economics and statistics. Should the functions be separated, combined, or coordinated? Should people espe-

cially trained in different areas also become thoroughly trained in the technology of the other party?

The basic techniques of accounting may seem purely statistical in nature to some people. This invites the belief that its statistical operation could easily be expanded and made more interpretative, but there is another side. The apparently statistical techniques of accounting deal, not with interpretation as such, but rather precede and prepare for the interpretation. These techniques include transaction analysis category integration, data organization and communication, audit and certification. These are much less statistical than they may seem.

Limiting Considerations

The limiting controls that form part of accounting are very significant aspects of this technology. The raw data are objective if restricted to those originating from the decision-actions of the management of a given enterprise. Thus they can tell of enterprise effort and accomplishment and of financial status. By restricting the raw data to exchange-priced transactions with outside interests, enterprise data are rendered arthimetically homogeneous, and thereby attain a needed capacity for being analytically marshalled into a variety of informative summaries.

In essence, the analytical techniques exist, not for the sake of the statistical data, but in order that an enterprise may become understandable from a study of the *integrated* data growing out of prior experience of that enterprise. The data resulting from enterprise experience are highly complex, because of the diversity of transactions and from their grouping into highly *integrated* classification categories. This complexity is only superficially visible in the financial statements. Yet penetration to the significance beneath the marshalled figures requires a knowledge of the intricate interrelationships among the data and of the enterprise changes that are reflected in them.

People within an enterprise have access to voluminous detail in the accounts and original records. People outside the enterprise, especially those working in the money market, find relatively little analytical data accessible upon which to base their studies except those disclosed in the published reports. This situation has undoubtedly influenced the evolution of financial statements. Modern data summaries are much more helpful to interpretation than those of fifty years ago. Yet reporting seems to be approaching a limit in this respect. For surely it would not be constructive to recast financial statements into other arrangements of statistical data at the price of the loss of the present close integration of real and nominal accounts. Business certainly would resist the idea of publishing all of the interpretative studies completed or possible within an enterprise. There would seem to be more in the term "private enterprise" than scattered ownership of its capital securities.

Possible Solutions

What can be done? Can interpretation be separated from analytical marshalling? Supplementary statement techniques seem to have been ignored. Have they been forever rejected? Can interpretative elements injected into financial statements be separated?

The lifo method of inventory ac-ounting may be mentioned as an ex-mple of an interpretative element hat has gradually been promoted into eneral acceptance in many areas by arious authorities. Yet this is more n expedient interpretation than a ogical, analytical part or essence of rior enterprise experience; it affects he reported amount of the cost of oods sold through an arbitrary ad-ustment of the asset account for goods ot yet sold. Some kind of service to ome statement users is no doubt per-ormed by this sort of inventory ac-ounting and, at least in theory, it is hought to affect the calculation of ncome taxes. The most significant oint, however, is the fact that this dea permits the introduction of an nterpretative element into the midst f otherwise logically marshalled nterprise-experience data.

Conclusion

Careful consideration of analysis and interpretation probably will show them separate in function with each requiring a different technique for its different function. When this is established, it would be particularly appropriate to propose a variety of supplementary disclosures to the usual financial statements, the latter being held sharply to analytical marshalling of prior enterprise experience.

The wide development and extensive use of supplementary interpretative information would have to face practical limits. What information could readers best use? How much of such information would it be feasible for businessmen to disclose? What kind of reasonable compromise could be found between these probably conflicting views? The determination of the correct response to these questions is the great task currently facing the accounting profession.

INTERNAL CONTROL EVALUATION METHODS

By Robert F. Dickey

Proper evaluation of the client's existing internal control for reliance thereon by the auditor, the second of three standards of field work, is essential to examinations performed in accordance with generally accepted auditing standards. The reliance an independent auditor places upon the client's system of internal control influences his selection of auditing procedures and his determination of the extent of tests to be applied. Therefore, proper evaluation of the existing internal control is necessary for the performance of competent auditing field work based upon tests and samples which, in accordance with generally accepted auditing standards, may be made in lieu of complete checks of accounting records.

A very effective aid used in this connection is an internal control questionnaire. Many accounting firms use printed questionnaires which provide for the names of the client's employees to be listed in response to questions concerning typical duties and responsibilities and for conclusions with regard to the adequacy of the controls in specific situations to be indicated therein. A few accounting firms use internal control questionnaires or check lists prepared specifically for each auditing engagement. Others use neither questionnaires nor check lists but instead prepare written comments pertaining to controls and conclusions with respect thereto. In any event, the extent of the auditor's testing and sampling is based in the first instance on the effectiveness of the internal control as indicated by the questionnaire or its equivalent, which is usually completed by inquiry directed to one or only a few persons in the client's organization. Subsequently, the results of the auditor's tests and samples, which serve also as a means of evaluating the effectiveness of the controls, are compared with the questionnaire for the purpose of making any necessary changes in the initial conclusions with regard to adequacy and for the purpose of planning additional tests and samples if considered necessary. In short, internal control questionnaires or their equivalents are designed to show the auditor the circumstances to which accountants refer in the second sentence of their short-form reports which reads in part, "as we considered necessary in the circumstances." Generally, these circumstances are described individually as situations; the good situations are subjected to minimum tests and the bad situations to extensive tests.

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Definition of Internal Control

Before considering internal control evaluation methods, attention should be directed to the definition of internal control issued in 1949 by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants in a special report entitled "Internal Control," as follows:

> "Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function."

Routine Tests

Inspection of selected source documents, tests of original entries in accounting records, proofs of selected additions and extensions, and tests of accumulations of accounting data are an important part of the auditor's evaluation of internal control. Tests of this sort should be sufficient to enable the auditor to satisfy himself with respect to many particular situations as indicated by the internal control questionnaire; they should, however, not be unnecessarily extensive, that is, to the point where the costs of auditing are not commensurate with the benefits to be derived therefrom. Good planning, through intelligent use of internal control questionnaires, is most important.

In addition to making routine tests of the accounting records, the auditor must also make observations of the daily routine or other activities of his client's employees. It is the purpose of this paper to call attention to a number of evaluation methods based on such observations and to suggest certain unusual tests that might be useful in specific situations; evaluation methods based on routine tests that are generally well understood by experienced accountants will not be covered herein. For example, the fact that sales invoices are pre-numbered and that the numbers are accounted for independently can be substantiated by routine tests or the fact that all persons who have access to cash and securities are bonded can be ascertained by inspection of the bonds. These routine tests are recognized as important evaluation methods but are not considered by auditors to be necessarily complicated or to require a great deal of imagination. However, the evaluation of internal control by observation and by application of unusual tests requires a great deal of imagination and therefore deserves very careful consideration in connection with each auditing engagement. The extent to which observations and unusual tests are to be applied is pertinent in this connection and should also be carefully considered.

Observations

Consider, for example, that upon inquiry directed to the client's con-

troller, the auditor is informed that all of the client's employees who have access to cash and securities are required to take annual vacations, and further that he considers it necessary to substantiate adherence to this policy. In many instances reference to payroll or personnel records will not disclose information pertaining to vacations or other absences of salaried employees; accordingly, the auditor's tests of management policy in this respect should be accomplished by directing inquiries to a number of persons other than the controller. Usually such inquiries can be made in a casual manner when vacation plans are being discussed by the client's employees. Tests of vacation policies are unusual and, therefore, require imagination.

So also are tests of the procedures followed by a client with respect to the verification of prelisted cash receipts. Mail lists showing follow-up notations may be reviewed in this connection and certain of them may be tested by tracing items listed thereon to cash receipts records; however, careful but friendly interrogation of mail clerks is usually necessary to establish the effectiveness of this procedure.

How can the auditor satisfy himself that checks are not signed in advance? He should be watchful for this possibility in those situations where authorized check signers frequently are absent from the client's office. While the auditor is present, he can of course observe the daily routine, but he should also inspect unissued checks several times on an unannounced basis if he has any doubts about this situation.

Observation of the daily routine in the client's office is necessary in many respects. Probably the most difficult matter to evaluate is the care with which authorized persons approve vendors' invoices and so forth. How can the auditor be satisfied that approvals are not perfunctory or routine? There is doubt that he can ever satisfy himself entirely on this point, but he can by casual inquiry make certain that persons who approve documents have knowledge of underlying details. Often this type of casual inquiry can best be made if the auditor asks for interpretative assistance or uses some other approach which suggests that the auditor lacks knowledge of the technical aspects of his client's business. He can also be watchful for opportunities to observe these persons at times when documents are presented for approvals; in this connection the auditor should be mindful of the possibility that persons authorized to approve documents may not be authorized to disapprove them. Other important procedures which should also be covered by similar observations and inquiries are:

1. Cancellation of vendors' invoices after, not before, approvals are affixed thereto.
2. Mailing of signed checks by check signers or their independent designees, rather than by the person who prepares the checks.
3. Prevention of loss or alteration of vendors' invoices by safeguarding incoming mail and by listing for control prior to entry in the voucher register.
4. Distribution of payroll checks by persons who do not prepare payrolls and who have no responsibilities in connection with payroll additions, terminations, or rates.
5. Prevention of unauthorized removals of merchandise or other goods from the client's premises by absolute adherence to prescribed procedures for physical and accounting safeguards.
6. Verification of quantities of incoming goods by independent counts or appropriate test counts.
7. Practices with respect to fixing responsibility for cash, which may often be

divided between two persons even though the intent is to the contrary.

To satisfy himself with respect to the foregoing items and other similar internal control procedures, the auditor should be especially alert to all available means by which he can determine the manner in which employees are discharging their responsibilities.

Unusual Tests

Evaluation of internal control by tests of non-accounting records may be possible in some instances. For example, in bank audits unannounced or surprise tests of addressograph files are very effective. Investigation of the names of bank depositors found in the addressograph files but for whom no accounts are maintained in the detail records are often revealing. For example, changes in the addressograph files are usually made by reference to a copy of the monthly report of accounts opened and closed which is submitted to the bank directors for supervisory purposes; omissions from this report may represent accounts closed because of poor service or discourtesy or they may represent accounts that in fact have not been closed. Similar tests may be applied effectively in examinations of non-profit professional associations whose main sources of income are members' dues.

Control of incoming mail for selected periods of time has been found to be effective not only as a test of cash receipts and miscellaneous income but also as a test of accounts payable controls.

If a client's investments in securities are material, investigation may disclose that records of these investments are maintained on a memo basis by the treasurer, assistant treasurer, or a member of the investment committee; a comparison of such records with the accounting records may be helpful in determining the effectiveness of the control over securities.

Sometimes budgets are considered non-accounting records; in these as well as other instances, auditors should compare budget estimates with results of operations and investigate major differences. This procedure can be effective even though the client's budget is nothing more than a scrap of paper based on unsophisticated sales forecasts.

It is also possible that reference to advertising schedules, reports of sales conferences, minutes of research committee meetings, and so forth, may help the auditor evaluate the controls over such things as discounts, returns and allowances, and no-charge invoices. Inventory controls may often be tested by reference to material-control records, stock-status reports, and other operating or production reports that are not used for accounting purposes. There appears no limit to the uses an imaginative auditor may make of non-accounting records. There are, however, limits to the reliance for auditing purposes which he may place upon these records and to the time he can devote to this sort of thing. These examples are intended only as illustrations of the importance of using available evaluation aids and not as suggested procedures that may be applied indiscriminately.

Extent

In addition to the judgmental decisions required to determine the extent of tests of the accounting records, the auditor faces similar and perhaps more challenging decisions to determine the extent of observations and in-

quiries that are necessary in particular situations. For example, how could an auditor determine that an assistant manager of a department store had access to cash and had thereby stolen $30,000 in the following set of circumstances:

> Access to cash was gained, without express authorization and without knowledge of persons other than a few clerks and one cashier, by relieving the central cashier in the basement budget store during her morning and afternoon coffee breaks. The theft was accomplished at the approximate rate of $100 weekly over a period of years by exchanging for cash fictitious cash refund slips, which he was authorized to approve. Observation by the auditors of the basement sales departments during the middle of the morning or the afternoon appears to be unreasonable in this connection. Interrogation by the auditors of all cashiers and sales clerks also seems unrealistic. No doubt this man was observed in the cashier's booth at some time through the years by store officials and accounting department personnel, but he apparently had good reasons for his presence there because he was not detected in this manner. Like many other fraud situations, detection resulted from an investigation prompted by the discovery of an improper plumbing repair bill which had been approved for payment by him. The plumbing bill represented charges for installation of a bathroom fixture in his home.

As another example of the difficulties encountered in connection with the extent of observations and inquiries, consider control of vendors' invoices as follows:

> In what appeared to be a good control situation throughout the organization, a man in charge of an office-supply storeroom managed to steal $40,000 over a period of five years. He was able to do this because invoices received from a certain office-supply house were subject to an exception in the routine controls exercised by mail-room personnel. The exception, a long-standing arrangement, was not known to the supervisor of the mail room or to the accounts payable supervisor or to anyone else of authority in the organization. Briefly, this man, subject to approval of requisitions subsequently prepared by him, placed orders for office supplies and related promotional prizes by telephone. The prizes included such things as golf clubs and appliances, which he was able to order in quantities in excess of his employer's needs. The extra prizes were in turn sold for cash. He then substituted vendor's invoices typed by him on printed vendors' invoice forms showing office-supply items in the same amount as the original invoice and showing the original invoice number. This fraud is more complex than indicated herein; however, the main point is that an exception was made in the control of vendors' invoices with respect to one vendor. Again, discovery of the fraud resulted from an investigation caused by detection of a minor irregularity in his handling of the sale of some used office equipment.

These two examples are cited to place emphasis upon consideration of the extent of auditors' observations and inquiries. Certainly in each situation the failure of employees to comply with prescribed control procedures could have been discovered if the auditor had observed the right person at the right time; however, to have accomplished this the auditor might have been compelled to observe all persons at all times. Between the extremes of too little and too much, the professional auditor should exercise careful judgment in his determination of the extent to which observations and inquiries are used as a means of evaluating internal control.

Conclusion

Proper evaluation of the client's existing internal control is essential to the performance of competent auditing field work. Evaluation methods used by independent auditors include tests of source documents and accumulations of accounting data, observations and inquiries, and tests of data not related directly to account-

ing records. Internal control questionnaires, either in printed form or otherwise, are useful in determining the adequacy of the control and as aids in planning the audit program. The independent auditor should use good judgment and exercise his imagination to the fullest extent in selecting internal control evaluation methods. Above all, evaluation of internal control should begin upon the auditor's arrival in his client's office and continue to the hour of his departure.

THE CASE OF NEWMAN, RUGGLES AND HANDLEY

"Continuing professional development"—the problem as seen through a partners' discussion in a hypothetical small firm

By Leonard Savoie

Dan Newman was noticeably disconsolate as he entered his large corner office on the tenth floor of the First National Bank Building. His two partners, Art Ruggles and George Handley, had already arrived and were engaged in a discussion of a financial report that lay open on the table before them.

Newman, Ruggles and Handley enjoyed a fine reputation as the leading firm of certified public accountants in Central City, Illinois, a thriving manufacturing and distributing center of 125,000 population. Their firm had been a success from its inception in 1935 when two young accountants, Newman and Ruggles, merged their small practices to form a partnership. Handley was taken in as a partner after the war. In 1959 their total staff consisted of the three partners, nine staff men and an office staff of three.

How We Lost a Job

Dan Newman began speaking, "I have just returned from the Amalgamated Machine Co. where I learned that the production control study they have been contemplating has been assigned to a large public accounting firm from Chicago. You know how badly we wanted to get this assignment. We have been performing audit work for this client for 20 years and have always provided a full accounting service including all phases of audit, tax and systems. We have helped them in many of their systems and procedures problems. In fact, our staff installed their cost and budget system. It was only natural that we be given the assignment to help them with their production control problem. However, the financial vice president told me today that he felt our staff did not have people properly trained to carry out work of this kind. And what is worse, he is probably right. We are at present limited in the areas in which we can render management services. I am somewhat embarrassed to admit this, but it has taken a reversal such as this to convince me of the need for a continuing education program in our profession."

George Handley spoke up, "Dan, you are absolutely right. But you have touched upon only one area

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where we need to emphasize continuing education and training. When I was down at the University last spring trying to hire two graduates for our staff, I found that we are severely handicapped by not having an adequate training program. That is, I think the profession in general is handicapped and our firm in particular suffers because we have no formal training program for our new men."

"Why George, we have as good a training program to offer new men as any firm in this city," interrupted Art Ruggles. "Of course, we do not have a formal training program—just how do you conduct a class with one or two students—but we do assign one of our senior staff men to spend several days with each new man indoctrinating him into our ways and familiarizing him with the auditing and accounting techniques he will be using in the next few years. Furthermore, all of our staff came to us as college graduates with training in accounting. All those who have passed the CPA exam are members of the American Institute of CPA's and the Illinois Society of CPA's at our firm's expense. They are encouraged to participate in Institute and Society activities."

Dan Newman countered with "Yes, this is true, Art, but these activities are not enough to constitute continuing education in a real profession. I know that we have been attending tax conferences and that you in particular have become known as quite a specialist in this field. I think, however, that the Institute is headed in the right direction in their initiation of a Division of Professional Development. Every major profession has a large body of training materials available to the members. The accounting profession has lagged far behind others in this area. Now we have an organized drive to overcome this deficiency in our profession. I think that we and every other practitioner are going to have to get behind it and support it 100%."

The Cost of Training

Art Ruggles tenaciously held onto his previous line of thought and proceeded, "Do you know the cost of a training course for new assistants? Are you willing to forego profits in order to develop your new men? Sometimes I wonder whether firms sponsor training courses for the sake of continuing education or simply to remain competitive with other firms in recruiting college graduates. If the latter is the case, it would make more sense to take the equivalent cost of training a man and hand it to him as a bonus for signing up. Fortunately we remain competitive because we live in a medium-sized community that is considered by many bright young men as a desirable place to live."

"We are in a unique position," said Dan Newman, "in that our profession is relatively new and we can advance rapidly by looking at progress made by the other professions. Facilities for professional development are much more extensive in the legal profession, medical profession and dental profession than in the accounting profession. Bankers, life insurance agents and business management personnel have better facilities for advanced study than we have. Our clients are becoming increasingly sophisticated as to the merits of advanced study. In fact several executives from Amalgamated Machine Co. have attended executive development courses at graduate schools of business of major universities. You know that the CPA

certificate has acquired considerable prestige and should be a great advantage to us in pursuing a continuing education program. At the same time, furthering our professional development should further our prestige. We have grown rapidly. Take our own firm for example, we have nine people on our staff, all of whom are under 40 and most of whom would be eager and enthusiastic about continuing education.''

Where Can We Get the Materials?

''But we do not have any basic material for the preparation of continuing education courses and lectures,'' broke in Art Ruggles. ''To get any real meaning from courses like this, we would need actual examples and cases taken from problems of our clients. You know that items of that nature are confidential and we would have a hard time developing any satisfactory material. We don't know that the Institute will have much success either in developing material. We have a good library right here in our office with more technical material than any one of us can probably absorb during the rest of our careers. Furthermore the public library and local college libraries are available and so is the Institute Library. We have the tools available now for those who are really interested in continuing their education.''

''You have brought up a point with which we all agree,'' said George Handley. ''We do have a body of literature, but self-education in the Abraham Lincoln style is not easy to come by. Some formal organization of education materials and an orderly group presentation are, I believe, vital to the success of professional development.''

Art Ruggles posed the question, ''Shouldn't continuing education be carried on by universities? They have the facilities and professors who are capable of carrying our programs of this type.''

George Handley said, ''I don't think that the universities can solve our problems for us, although they can be instrumenetal in helping us achieve our ultimate objectives. Professors at the University have told me that they would very much like to be advised by the accounting profession as to how their curricula could be improved and updated to be of greater service to the accounting profession. I am sure that these same professors would be very happy to cooperate in helping the profession conduct a continuing education program.''

Ruggles again spoke, ''It seems quite frustrating to me for us to spend a lot of time and money training our younger men when experience shows that most of them leave us after four or five years. I don't see where we should be required to train people for positions in business outside our profession. You know we have another serious handicap for conducting training programs and this is the substantial out-of-town work that some of our men have. That plus the increased demands of our staff during the busy season makes it very difficult to establish a training course at a time when it could be attended by those persons most in need of it.''

What Is the Answer?

Dan Newman meanwhile reflected on the various matters being considered as he gazed out over the city and spotted the busy plants of several of his clients. He mused aloud, still

thinking about the jolt he received earlier in the day, "Our firm, in order to continue to grow and thrive, must take an active position in encouraging and fostering the continued professional development of its partners and staff. We must develop our own specialists where there is a need for specialized services. Can we expect our professional organizations to do this job for us? Not entirely, of course, but through professional organizations we should be able to make some real headway in professional development. This is not the same profession as it was when we started 25 years ago, and it will not be the same in another 25 years from now. Just as an example of new areas opening up to the public accounting profession, the social and economic changes being wrought by the large concentration of wealth in corporate pension trusts and union funds are calling for increased services of independent public accountants. We need to keep abreast of the latest techniques in accounting and auditing, machine accounting, statistical sampling and a host of other areas, as well as those we have already talked about. Our profession faces a real challenge."

THE ROLE OF THE SENIOR ACCOUNTANT

By W. D. Harris

Anyone connected with the profession of public accounting for any length of time who has talked with a group of accounting students will recall seeing the blank, perhaps quizzical look that generally appears on the faces of these students when the term "senior, or in-charge, accountant" is mentioned. Likewise, we who have been in public accounting can probably remember vividly the feeling of complete incomprehension when we, as "green" junior accountants, reported on our first day of field work in the profession and were told to report to our first senior accountant.

Generally, both the accounting student and the new junior accountant have a reasonably accurate understanding of the duties and relative positions of junior assistants, principals or supervisors, and partners. However, neither of the two generally has more than a vague idea as to the importance of the senior accountant and of the responsibilities he assumes.

This lack of knowledge about an important member of the profession can be attributed in part to the fact that usually the articles dealing with public accounting aim at providing an understanding of the functions of individual practitioners or partners of larger accounting firms. In articles which do pertain to the staff level, the emphasis is generally on the duties of the junior and seldom is the senior accountant mentioned.

"What do you do?," "what is your future?," and similar questions are constantly being asked of the senior accountant by new juniors in the firm. The same questions are often asked by college students when talking with public accounting firms of prospects of future employment in the profession. That these questions are constantly being asked indicates that these relatively new, or potentially new, members of the profession are interested in learning more about the senior accountant. Probably other students and junior accountants would like to ask the same questions but have not had the opportunity. With this in mind, it is intended to present in the discussion which follows, a word picture of the senior accountant as seen by one of them. In doing this, an attempt will be made to explain the duties and functions of the senior accountant by viewing him from the four levels of analysis to which he is constantly subjected: from outside, in other words, as he is viewed by clients and the business world at large; from above by partners and principals; from below by assistants and juniors; and from within by himself.

It is hoped that the resulting pic-

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ture and explanations will be useful, each in their way, to the accounting student and the new junior. Perhaps the accounting student in reading the description herein of some important, interesting, but not well-known phase of public accounting may be stimulated to examine the profession more closely and so be guided eventually to enter it. Likewise, the very new junior may find the profession a little more interesting if this article gives him a better insight into the profession and the level of attainment which will be one of his early goals should he enter the profession. About this he is usually quite vague at the time of his entry into the field.

From Outside

Generally, the senior accountant is the person whom his firm's clients will see most frequently and with whom they will be working most closely. In fact, to these people, the senior often personifies the firm. Needless to say, his personal appearance and tactfulness are important attributes in his contacts with clients.

The impression he creates contributes largely to the client's impression of the value of the service being rendered. His manner at the time of first contact, his method of delegating work to his assistants, his ability to question, answer, discuss, and search intelligently, and his faculty to give the client an awareness and assurance that the examination is being capably executed, largely determine whether or not his firm and, by inference, his profession, are favorably regarded by the client and by the client's employees.

In his contacts with people outside the profession, including the client's employees, the senior accountant finds an excellent opportunity to correct some of the misconceptions concerning the work of public accountants. Even today, when the public's understanding of the business world is more complete than ever before, too many people still believe that a public accountant is primarily interested in discovering errors or disclosing fraud; they do not understand the far more important reasons that make the service desirable and, in fact, necessary.

Because the senior's contacts with the client are more frequent than those of any others in his firm, he has greater opportunity to explain by words and actions the position and importance of the profession, and thereby to assist the public to a better understanding of the profession.

From Above

The senior accountant is under the constant supervision of those above him, the partners and principals of his firm, who previously had been senior accountants. Therefore, they are aware of his problems and responsibilities, but know also that he is the person on the staff who has the "fun" of the examination. The part his supervisors play in conducting the engagement lies in their orderly preplanning and subsequent careful supervision. They long ago evaluated the capabilities of this man who "works for them" and they now put their trust in him to carry out their plans and execute their engagements in a professional manner.

The senior accountant must show the partners and principals that he can fulfill their expectations and justify their confidence and trust by completing as thoroughly and, yet, as rapidly as possible the varied duties delegated to him. Also, he must show

that he can "run" his jobs, and at the same time supply the immediate planning and direct supervision for most of the staff.

If the senior accountant is able to demonstrate to his supervisors that he has ability to cope with current situations as they develop, shows resourcefulness, and possesses the required ability, he will find that after sufficient "seasoning," he will have every opportunity to become a part of the pool from which his supervisors can consider drawing replacements to provide for the continuity of the firm.

One cannot question the fact that the senior accountant has other responsibilities and duties to those above him, but since his reaction to them comes from within himself and can be seen most clearly from the point of self-analysis, they are discussed later under that heading.

From Below

To his assistants, the senior accountant is a guide on the path of public accountancy. The good assistant will study his immediate supervisor closely and will glean from his examples and decisions the methods to be followed, to be discarded, to be improved upon. Anyone ever in the profession remembers his first senior accountants: how they worked, acted, talked, and so forth. As experience is gained, the assistant learns to observe and begins to acquire a portion of his senior's process of evaluation which is so important in public accounting work. In doing this, the assistant naturally leans on his senior; he looks for encouragement when correct and explanation when in error. Also, it is from the senior accountant that the assistant first learns that mastery of accounting theory alone does not make a good public accountant, but that without such knowledge his cause may well be hopeless.

Perhaps the most important responsibility that the senior accountant has to his assistants is that of giving adequate explanations about the purpose or need for a particular task asked of the assistant. By explaining the reasons for doing various types of verification or the need for certain information, he makes the performance of the sometimes menial-appearing tasks of a new assistant meaningful and increases interest and improves results, thereby speeding the development of his own eventual successors.

From Within Himself

In every facet of his daily duties one general pattern is necessary and expected, the senior accountant must constantly evaluate happenings, situations, procedures, theories, assistants, and other people. Therefore, who is better qualified to evaluate the senior accountant than he himself?

For the successful senior accountant, the days of a quick introduction and the display of a "get out of my way so that I can work" attitude are past. He is grasping at the bottom rung of the ladder of management and so must be capable of doing more than producing piles of work by his own hands. He must plan carefully but not inefficiently; think but not ponder; consider the client's problems and limitations but not lose sight of his purpose; direct his men but not subject them to tyranny; and be affable but not forgetful of his professional responsibilities.

What traits and abilities go into making a senior accountant? Assuredly, technical training and ability are prime requisites, but such must be

assumed to be present in order for him to have reached this level. The added qualities that make, or break, aspirants include: poise gained through experience and the resulting self-confidence; desire to accomplish; ability to get along with his assistants, treating each in the manner necessary to get the best efforts from him; and the ability to meet problems resourcefully and to maintain for his firm the respect of the client.

His ability to accept this position of trust and confidence with the proper degree of humility and professional dignity is undoubtedly one of the most important character traits he can develop.

What is the most important duty of our subject? There can be no doubt that he owes his superiors a high degree of loyalty plus all of his ability and the benefits of his experience and that he owes the clients a well-executed examination. His desire to satisfy both of these groups can be taken for granted in that by fulfilling these duties he is benefiting himself and progressing along the road of professional development. Perhaps his next most important responsibility from the standpoint of his firm and his profession is aiding in the proper development and training of his assistants.

How does he discharge this? The senior accountant has a duty to his assistants to apply the proper expedients for their orderly development in the field, much as a diamond polisher must use his art to bring forth the sparkle and luster of a rough diamond. These expedients include, but are not limited to, developing the individual's good traits and bettering those less desirable, providing proper supervision and progressively stimulating assignments, steadily creating self-confidence, and forming an awareness of time and materiality. Each of these should be supplied with the same care that has been given to his own development.

What is his most serious fault? Probably the most serious one is that he is so intent upon completing his jobs or meeting his schedules and deadlines that he tends to forge ahead without first giving his problems complete thought. In this respect he is very much like the city pedestrian, who, upon arriving at an intersection and seeing a car a short distance down the street, instead of hesitating momentarily and then proceeding in safety, spurts across without proper consideration of the risks in order to save the waiting time.

What are his rewards? The rewards are varied, many perhaps appearing to be far from rewards when first encountered—such as the uneasiness resulting from the ever-present cold, factual, perhaps even distaseful self-criticism, probably made subconsciously, or the undesirable task of having to coldly evaluate the work of his assistants even though they may be his friends and the final results of their work may not be too flattering to them; however, each task when completed yields a feeling of accomplishment. The rewards come from grasping new and differing problems, from contending against but meeting deadlines, or from the thrill of turning in a job knowing it has been well done. It is true that by the nature of the profession he cannot always expect to be told, perhaps not even by inference, when a job has been well done; but, nevertheless, the satisfaction is there. One asset to be gained by a senior accountant that proves in-

valuable to him in more ways than are merely professional is the keen awareness of time that becomes incidental to his duties and requires him to develop further the habits of planning and scheduling. Finally, a senior accountant acquires an ability to delegate authority and to command men, for he must learn early in this phase of his professional development that he is considerably more valuable for what he has the assistants under him do than for the work which he personally can turn out. This follows naturally from the fact that his major task is to provide direction and guidance for his crew.

What ability required at this level is the most difficult to develop? Without a doubt, at the senior accountant level, the ability to write becomes increasingly important and is probably the most difficult to acquire. Generally, wording techniques and practices observed in the firm's correspondence and reports now begin to assume a prominent place in the senior accountant's thinking. In his capacity of in-charge accountant on particular engagements, he is expected to draft reports, letters, and memoranda incidental to audit engagements. The new senior accountant must begin to plan what he writes, be selective in his use of words, and learn to be concise but not curt in his statements. Such written work requires the utmost output in terms of thought and time, but the senior accountant should not be discouraged if he sees that major portions of his early attempts end up with numerous revisions and corrections. He should remember that while the original draft may have been substantially changed, it has served as a point of departure from which his supervisors could produce a finished report much more quickly and probably with considerable less over-all thought than if they had to do the original writing. The attainment of proficiency in drafting reports and letters will be facilitated for the new senior accountant if he, as an assistant, has followed the practice of using reasonably correct grammar and of writing complete sentences and paragraphs in his working-paper comments.

What is his future? The senior accountant is on a plateau of decision, of ambition, of vision of the future—a spring-board to greater and higher peaks of performance, satisfaction, and accomplishment in his field. Or, if he does not choose to remain in the profession, it is usually at this stage that he has the best opportunity to select a particular side of the business world that appeals to him from the many to which he is continually exposed.

What is his potential, monetarily? Without becoming involved in staggering arrays of statistical data, the figures presented in the following table selected from a recent survey * made by the American Institute of Certified Public Accountants appear to answer this question quite adequately:

	Median Annual Income
All practitioners and partners over age 35	$12,716
All practitioners and partners over age 35 according to size of office:	
Having 5–9 CPA's (including staff)	$18,318
Having 10 or more CPA's (including staff)	Over $20,000

* Bulletin 1, Economics of Accounting Practice, *Income of Practicing Certified Public Accountants*, Appendix A, Tables 1 and 3, pp. 31 and 36, respectively.

The last two figures appear to be significant in any study of monetary potential because it must be assumed that the reader is interested in the results that an aspirant to a career of public accounting may expect on reaching his goal—success in the profession; and most public accounting firms interviewing applicants at the various colleges and universities can be expected to average five or more CPA's as partners or staff members in each of their offices.

Is this the end of his study to advance his personal competence? No! He must constantly keep abreast of current developments, and repeatedly refresh his previously acquired knowledge. He will be surprised at the differing interpretations occurring with each refresher because of added experience since last contact. This is also the level where our subject must begin to do what he can, possibly only in a small way, to be of public service, a duty which will be increasingly expected of him as he progresses to higher levels in the profession.

In conclusion, it must be considered unfortunate that every accountant outside the field of public accounting does not have the opportunity to be a senior accountant sometime during his career. There is probably no other stage in an accountant's life or career when professional and technical happenings are as interesting, or as full, and yet as unnerving as at the start of this phase. It is characterized by mixed emotions that may be aptly compared with those of the fisherman who, getting into a strange boat of questionable sea-worthiness, can see the "whoppers" jumping and splashing out in the deeper part of the lake.

The picture presented and the explanations given in this article may not be complete; and, certainly, the concepts are not necessarily original. However, the writer's intention has been to provide a picture of the senior accountant drawn along lines of the results for which we strive, but which many of us in the end may unfortunately not attain. Perhaps this description of an important but seldom discussed phase of the public accounting profession will encourage some hesitant accounting student to investigate public accounting and, finding the profession interesting, the work provocative, and the promised future rewarding, to enter the profession. Or perhaps some new junior will find a little more information about his chosen field and thereby obtain a somewhat better idea of what he is striving for, and gain a little more confidence as he moves toward this early goal in his professional life. At least, it is hoped that both of them will have a better understanding of the importance and responsibilities of the senior accountant.

Controllership Opportunities in Profit-Planning

By Maurice B. T. Davies

The controller has many opportunities to assist his management in the maximization of profits. We shall consider a few of them. In so doing, we shall omit such equally important areas as:

(1) planning for the control of costs
(2) planning for capital expenditures
(3) providing for tax-shelter
(4) using integrated data processing equipment.

Even apart from these important considerations, the role of the controller is an extremely wide one, and his impact on the profitability of his company can be of major significance.

Let us assume that John Doe has just been appointed controller of a company whose business is manufacturing oil equipment and that it has some twenty distributing centers. Let us assume, too, that it has grown fairly rapidly and now has a payroll of 1,000 employees. John Doe has been appointed because the management realizes that its chief accountant, while competent to prepare monthly financial statements, has not been providing the top management with the counsel it needs for proper financial management.

Within this framework, what are some of the areas that the new controller should explore in order to provide maximum service to management in the creation of profits? Some o these areas and the related opportun ities open to the controller are:

(1) Organization and management of th accounting function
(2) Management reporting
(3) Break-even-point controls
(4) Long-range planning
(5) Research and development perform ance.

1. Organization and Management o the Accounting Function

In such conditions as described, w may expect to find an accountant wh is exercising laborious efforts to main tain a good set of double-entry books His monthly financial statements ar issued later than the managemen would desire because of the necessity for getting everything recorded. Hi staff has relatively loosely defined re sponsibilities . . . (after all, they al know what they have to do) . . . and nearly every accounting decision o any significance is made by the chie accountant. He has a crude form o budgeting in effect, but, as this ha nothing to do with his double-entry accounts, he has delegated this to a clerk whom he supervises very little and this clerk has the responsibility of direct contact with management The chief accountant makes a rough estimate of the tax liability every

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ıonth, but all tax returns are handled y the company's auditors. He personally makes all decisions relating o new procedures, and he has an nternal auditor whose task is to review invoices before they are paid.

These conditions may sound very nuch exaggerated, but, unfortunately, hey are too often typical. One of the ıew controller's first tasks, therefore, s to put his own house in order. He hould do this because the operation f the accounting system should absorb a minimal amount of his time n the future.

The controller may accomplish this y taking the following action:

(a) Make logical assignments of accounting duties

One of the first tasks is to determine vhat accounting work is being done and who is doing it. This should then e carefully examined, and decisions should be made and formalized:

(1) to specify individual responsibilities of the accounting staff
(2) to identify action which should be delegated and the type of review necessary
(3) to define reporting relationships at all levels, including a decision as to whom should report directly to the controller
(4) to establish reporting relationships outside the controller's division.

(b) Install an effective accounting manual

If a chart of accounts is not in existence, one should be installed; if one s already in effect, it should be reviewed to see whether it is adequate r modified to the extent necessary.

A chart of accounts merely identiies the various accounts by numerical r alphabetical codes. In addition to his, there should be a clear definition f what types of items go into each ccount. This requires the preparation of descriptive material in harmony with the chart of accounts.

A good accounting manual is needed, both for reference purposes and for staff training. In an accounting department of any appreciable size, such a manual is an essential work guide.

(c) Review and modify working methods

The accounting procedures should be examined with special emphasis upon possibilities for:

(1) speeding the flow of accounting data
(2) producing more meaningful information
(3) simplifying the work
(4) combining work of substantially identical types
(5) eliminating unnecessary work
(6) reducing accounting costs
(7) using estimates where these are acceptable
(8) producing monthly accounts more rapidly.

The new controller should guide this review, but should not undertake it himself. He should assign one of his staff to handle this task, or, if he has nobody of adequate caliber available, he should seek the assistance of the company's certified public accountants.

All procedural changes should be properly documented, and definitive procedures should be written for the more complex functions which are not changed.

(d) Examine the budgetary system

The budgetary system, with its previously described low management-type approach, obviously needs a thorough overhaul. The new system should provide for:

(1) controlling all areas of significance
(2) correlating the budgetary system with the accounting system

(3) establishing responsibility accounting
(4) producing effective budgetary reports in a form that can be understood by the management
(5) introducing graphical techniques for reporting progress and significant deviations from plans.

In developing a budgetary system, the controller should work closely with the management to assure a full understanding and a maximum degree of participation.

(e) Re-evaluate the internal audit

It is unrealistic to assume that a voucher examination constitutes an internal audit, for it is merely a part of the regular payment process. The new controller should study the overall situation and determine whether an internal audit is needed. The advice of the company's external auditors should also be sought in this connection.

The establishment of an effective system of internal audit entails additional expense. If, therefore, it is decided to introduce such a system, the staff should be of modest size, initially perhaps only one man. Authority, responsibility, and working methods should be carefully defined, and continuous review should be made of the progress achieved.

These, then, are some of the steps the controller should take to put his house in order. It seems logical for him to assign to the chief accountant the task to keep the present accounting system functioning and to select one or more of the accounting staff to assist him in planning developmental work. As he becomes more familar with individual performances, the controller can then appoint selected people to take over key positions.

2. Management Reporting

One of the controller's principal relationships with his management is that of being a communicator. Not only should he generate a flow of significant information to the management, but the controller must also act as an information center, providing details as called upon.

Under the conditions previously described, it is likely that the chief accountant will provide little more than the natural output from his books of account. What, then, should the new controller do?

(a) Take an inventory of management needs

The controller should learn from the various members of the management team those types of financial, accounting and statistical information needed. He should determine the general information acquired informally and the accounting-type information developed independent of the accounting department. These determinations should provide useful clues.

(b) Examine the present reporting system

The existing reporting system should be related to management's expressed needs. Particular attention should be given to the opportunities for reducing the quantity of data reported and for allowing full exercise of the concept of management by exception.

(c) Develop a sound reporting format and system

A comparison of current needs with current practices should lead to the development of an adequate reporting system. This system should have the following qualities:

(1) Reports should be geared to the needs for management decision-making.
(2) The accounting system should be modified, wherever necessary, to facilitate effective report preparation.
(3) Reports should contain significant data even if derived other than from the accounting records.
(4) Information should be reported as promptly as possible, using "flash reporting" techniques whenever feasible.
(5) Reporting formats should be accepted in advance by the people who are to receive the reports.
(6) Narrative explanations should support figure-type reports.
(7) A schedule should be prepared to serve as a check-list, coupled with definitions of responsibilities, to assure that reports are produced on time.
(8) Provision should be made for reviewing reports before they are released.

The reporting system should always be regarded as flexible, and the controller should be constantly alert to the necessity of anticipating management requirements and gearing the accounting system accordingly.

3. Break-Even-Point Controls

An important tool in profit-planning is the break-even analysis. This enables management to review the status of profitability, based upon varying levels of volume and product mix; this is particularly significant in planning for a manufacturing business. The controller should utilize break-even-point concepts in the developing of an over-all profit plan.

(a) Determine cost and volume levels on a "planning-unit" basis

For profit-planning purposes the business should be subdivided into planning units, each representing an organizational segment. The relationship of the various unit plans should be compared to the over-all profit structure so that any deviation of *planned* profit from *desired* profit can be identified as to source, reason, and amount. Deviations may be managerially corrected through budgetary adjustment.

(b) Study the impact of changing conditions on the break-even-point

Circumstances beyond the company's control, as well as company-induced conditions, can materially affect the break-even-point. As these occur, the over-all break-even-point condition should be restudied to see whether changes in plans are necessary.

The use of break-even-point control techniques enables the company to budget more effectively. It provides for deviations from established profit objectives to be examined *during the planning stage*. This is in contrast to the post-mortem type of review derived solely through the use of standard cost variances or budgetary comparisons. Corrective action can thus be considered *before operating plans are finalized*.

4. Long-Range Planning

One of the greatest weaknesses of conventional accounting methods is the tendency to review operations in terms of separate annual cycles, whereas, in reality, business consists of a continuing operating flow during which annual accountings are of significance mainly for reporting progress and paying taxes. As a result, profit plans tend to be constructed only for a single fiscal period, and as each year passes, the period of planned operations progressively decreases. This may be overcome in either of two ways or by a combination of each.

The planned period may be progressively prolonged at stages during the year. For example, the plan may consist of a single quarter budgeted in exact detail and the succeeding three quarters in broad detail. As each quarter passes, the planning process is repeated and an additional quarter is planned.

Two plans may operate concurrently—one relating to the current fiscal year and the other to a long-range plan, covering five years, ten years, or even longer period. Continuity is achieved by correlating the two plans.

A new controller should move warily into the field of long-range planning, seeking first to improve his techniques for the period just ahead. He should be guided by the following considerations in producing a serviceable plan:

(a) Gain full concurrence and participation by the management group

The long-range plan is a managerial function; the controller plays only a limited, but important, task. Management will generally need to plan in terms of broad policies and to examine the impact of these policies through reference to expected economic conditions. Competent economic analyses are normally necessary for this purpose, and may be available only outside the business. The controller should attempt to provide such analyses only if he is thoroughly skilled in this respect.

(b) Produce a statement of the long-range plan

When developed, the plan may extend into the future for varying periods. For example, capital expenditures may be planned ten years ahead, whereas sales may be forecast for only five years. Moreover, the plan will generally be tentative in many respects and subject to change as more facts become known.

The plan accepted should be recorded, showing the areas requiring particular future consideration, specifying the assumptions used, identifying deadlines for future action, and indicating the planned profits and financial position.

(c) Coordinate the long-range and short-range plans

The passage of time will result in portions of the long-range plans being used for short-range (year-ahead) planning. The two plans should therefore be expressed in terms that enable them to be readily combined and permit an easy conversion from long-range into short-range planning.

The controller who is able to assist in developing a long-range plan generally builds himself into a position of greater value to the other members of the management team. He is able to evaluate short-range decisions in the light of their long-range impact and thus strengthen his ability to counsel wisely. And his task of routine budgetary preparation should be considerably eased with a well-defined pattern for the future lying before him.

5. Research and Development Performance

A phenomenon of recent years has been the increasing expenditure by American businesses on research and development. It is also interesting to observe that many of the nation's most successful businesses make unusually large expenditures in this area. It is an area, however, that seems little understood by the average

ccountant; he is often content merely o record the amounts spent and to ompare them with a budget rather ian to evaluate the efficiency and ffectiveness of the function.

There are two significant ways in hich the controller can assist man-gement in this connection:

a) Review the efficiency of the activity

The controller, personally or irough his internal auditor, should e able to gain an accurate picture f the efficiency of the firm's research nd development activity. His periodic eviews should involve questions on ich matters as:

(1) the development of an operating plan as a basis for action
(2) the assignment of work on a project basis
(3) the control over researchers' time
(4) the proper scheduling of each project
(5) the maintenance of effective facilities, laboratories and libraries, and the proper use of them
(6) the exercise of prompt action on completion of each project
(7) the maintenance of a realistic balance between pure research and applied research
(8) the conduct of practical liaison with the rest of the operating management to assure that the activity is geared to business needs
(9) the adoption and exercise of sound expense controls.

b) Evaluate the effectiveness of the activity

No matter how efficiently the re-earch and development function is erformed, it may still fail to produce ffective results. The controller can roduce a sound evaluation of the ffectiveness of this activity in mone-ary terms. The evaluation should extend over a period of years because of the normal lag between the beginning of work on a project and its ultimate production of economic benefit and would involve the following:

(1) Determine the amount of profit produced and producible by each research and development project.
(2) In the case of profits not yet materialized, discount the profits of future periods because of the factor of uncertainty, the prospect of changes that might reduce the profitability, the cost of money, and other factors.
(3) Apply a money value to other services performed by the research and development group, based on a market value agreed upon between the research and development staff and the department receiving the service.
(4) Total the expenditures of the research and development group.
(5) Subtract the total expenditures from the sum of discounted profits produced and services provided. If the result is a plus figure, it tends to denote that the activity has been effective.

While it is important to evaluate the gains produced from this function, it would be unwise to assume that an arithmetical calculation alone can reveal its effectiveness without also considering those intangibles incapable of monetary expression. Nevertheless, business management should have a guide, even though in approximate terms, of the contribution made to its profits by its research and development staff.

Although the features of controllership discussed above were selected at random, they bring into focus the many opportunities for the controller to assist his management in planning for profit. Controllership may be an onerous task, but it offers great satisfaction by opening up new resources necessary for the future prosperity of the business.

Were You There?

Where? Why At The Annual Meeting, Of Course!

Be sure you are among the happy people at the 1960 annual meeting on June 5-7, 1960, at the Drake Hotel in Chicago, Illinois

Low gross winner of the Illinois Society's 1959 annual golf tournament was Frank W. Hianik who is associated with John Morrell and Company, Chicago.

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

RECENT DEPRECIATION DECISIONS AS THEY RELATE TO LEASE-FINANCING

Recent court decisions regarding depreciation, useful life, and salvage value have evoked considerable comment and controversy in the tax literature. It seems worthwhile to summarize these important decisions and to discuss their possible significance to the important related problem whether to lease or purchase equipment.

The Hertz Corporation

The taxpayer claimed a four-year life for automobiles which were used for an average of twenty-six months. Depreciation was computed by the double-declining-balance method without any reference to a salvage valve. The automobiles were then sold with the resulting gain taxed at capital gain rates under Section 1231. The Commissioner challenged this practice and the case was first heard in the District Court of Delaware (165 F. Supp. 261, 7/17/58). The court addressed itself to three important questions:

(1) Does "useful life" mean the life inherent in the asset, or the period it is held by the taxpayer? (If it means the latter, Hertz would not be permitted to use the declining-balance method which requires at least a three year life).

(2) Should salvage value other than th built-in residual be a factor in the de clining-balance method of deprecia tion?

(3) May the regulations regarding "use ful life" and "salvage value" pub lished in 1956 be applied retro actively?

On the question of "useful life" th court cited a 1919 Treasury Regula tion and a 1927 Supreme Court de cision (*U.S.* v. *Ludey,* 274 U.S. 295 to the effect that originally the term meant the period used in the business However, the court then went on t cite later decisions, the wording o Bulletin F, and the expert testimon of certified public accountants, an concluded that by 1954 the term "use ful life" had come to mean the entir physical life of the asset. The cour further supported this position b citing Congressional Committee re ports and concluding that Congres intended to change the meaning o "useful life" in the 1954 Code. Thi new meaning first appeared in th regulations published in 1956, and th court decided that "common justic requires that it be given a prospectiv construction only."

Thus the decision was that Hert had followed usual practice an should be allowed to use the four yea

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fe up to the publication of the new egulations in 1956, but under the ew meaning included therein Hertz hould use the shorter life after 1956 nd therefore could not use the declinng-balance method.

On the question of salvage value, nly two references were cited: (1) he Commissioner's own instructions n Form 2106 (worksheet for computng automobile expenses) stated "if eclining balance method of depreciaon is used, disregard salvage value n computing depreciation."; (2) the enate Finance Committee Report on he 1954 Code stated that " . . . at he expiration of useful life there remains an undepreciated balance which epresents salvage value." The court oncluded that " . . . salvage value ther than that which is inherent in he method is not a factor in deterining depreciation under the delining-balance theory of depreciaon."

The Commissioner appealed this ase to the U. S. Court of Appeals, hird Circuit, which rendered its deision on July 6, 1959. This decision eversed the District Court on almost ll points.

The appellate court also cited *Ludey* ut then concluded that subsequent ases were inconclusive and did not ndicate a change from the early defiition of useful life as the life to the axpayer. Among the subsequent cases ited were *Evans, Massey Motors,* nd *Cohn* (all discussed below); all hese decisions had been handed down y appellate courts after the original *Iertz* decision.

The appellate court countered the istrict court's reference to Bulletin F y citing different wording from the ame Bulletin F which refers to "... seful life of the property in the business . . ." The expert testimony for the taxpayer of three national firms of certified public accountants was refuted by reference to *Montgomery's Federal Taxes,* 37th Edition, which clearly defines useful life as life to the taxpayer. Furthermore, *Montgomery* states that this has always been the proper definition; it was concluded that there has been no change in definition and "useful life" has always meant "in the taxpayer's business." In this connection it was emphasized that neither the taxpayer nor the Commissioner has ever contended that the new regulation changed the meaning. The District Court had discussed such a change in meaning although both contesting parties had maintained that their respective definitions had always prevailed.

On the question of salvage value the earlier reference to the Senate Committee Report was refuted by reference to the House Committee Report which stated that the new methods of depreciation "... merely affect the timing and not the ultimate amount of depreciation deductions with respect to a property."

Thus, as the *Hertz* case now stands, "useful life" means "in the taxpayer's business" whether before or after the regulations were published in 1956, and, where declining-balance depreciation is permitted, it may not be used to depreciate an asset below a reasonable salvage value. On October 12, 1959 the Supreme Court granted certiorari in this case as well as in *Massey* and *Evans.*

Evans v. Commissioner

The *Evans Case* also concerned rental automobiles. The taxpayer depreciated the cars over a four-year life with no salvage value, but used

the cars for only fifteen to seventeen months. The tax years involved were 1950 and 1951 so the declining-balance method was not at issue.

The Tax Court (16 TCM 639) ruled in 1957 that the taxpayer should have used an average life of 15 months and an average salvage value of $1,375. In the appeal the taxpayer maintained that the courts, the Commissioner, and accounting practice in general had long based the depreciation deduction upon the physical life of the asset with a salvage value no greater than the residual or scrap value of the asset.

The appellate court reversed the Tax Court on both points on January 26, 1959 (CA-9, 264 F.2d 502), and held that Evans was entitled to use a four-year life and a salvage value equal to the scrap value. In reaching this decision the court cited the regulations issued in 1956 and quoted extensively from the District Court *Hertz* decision. Thus, with essentially the same evidence and essentially the same type of case, the Ninth Circuit agreed with the District Court decision while the Third Circuit reversed that same decision.

Massey Motors, Inc.

The taxpayer in this case was an automobile dealer who, in addition to selling automobiles, also used some of the cars as executive or employee cars and rented others for various periods up to one year. On both the company cars and the rental cars, depreciation was deducted based upon a three-year life with no salvage when no more than one year old, and value. All of these cars were sold in nearly all cases they were sold for more than the taxpayer's original cost with the resulting gains reported as capital gains under Section 117 j (now Section 1231).

The Commissioner objected on two counts. First, he contended that these automobiles were held for resale in the normal course of business, and, therefore, the gain would be ordinary income. Secondly, he contended that with a useful life to the taxpayer of one year and a salvage value at the end of that time greater than cost no depreciation deduction should be allowed.

The Florida District Court, in 1957, ruled for the taxpayer on both counts (156 F Supp. 516). Upon appeal the Commissioner conceded the first point that the gain was subject to Section 117 j and that the appellate court had to rule only on the question of depreciation calculation. The taxpayer argued that useful life meant the full life of the asset which was maintained to be three years. The taxpayer further argued that salvage value meant scrap value at the end of the full asset life which was claimed to be zero.

The appellate court reversed the District Court on the depreciation question on February 26, 1959 (CCA-5, 264 F. 2d 552). It cited *Ludey*, Bulletin F, and the new regulations of 1956. In a footnote the court referred to *Montgomery, 37th Edition*: "For a clear and convincing discussion and analysis of this problem, leading the author to the same conclusion we have reached. . . ." In effect, the Fifth Circuit ruled (as had the Third Circuit in *Hertz*) that the new regulations do not change the calculation of depreciation and that even in 1950 and 1951 "useful life" meant "in the taxpayer's business" and "salvage value" meant value at the end of such useful life. The court

acknowledged the fact that it was reaching a conclusion contrary to the one reached by the Ninth Circuit in *Evans* just one month earlier.

JOHN V. COMMISSIONER

This case dealt with various types of equipment necessary to operate flying schools for the Army Air Corps from 1941 through 1944. The taxpayer and the Army Air Corps had agreed that ". . . December 31, 1944 represented the reasonable maximum duration of the Civilian Contract School Program." For this reason all assets were written off over the period from acquisition to December 31, 1944. No salvage value was used although other similar schools used a 10% salvage value. Late in 1944 the assets were sold at auction at substantial profits.

The Commissioner disallowed some of the depreciation under the contention that the useful life should have been ten years for shop, ground school, and canteen equipment, and five years for the other equipment (including automobiles). Thus both the Commissioner and the taxpayers were advocating views contrary to the positions held in the other cases. Aparently, if depreciation were taken over the full life of the asset, the Commissioner agreed that only scrap value must be considered as salvage.

The District Judge (D C Tenn., 1957) originally ruled that the taxpayer had used the proper useful lives, but that a 10% salvage value should have been used for all movable equipment. This ruling was made in February, 1957; however, before the entry of judgment, the government requested a further finding of fact and a further hearing. The government's further argument was that in the final year, when the assets were sold, their actual salvage value was known and no depreciation deduction should be allowed for that final year which would reduce the assets below such actual salvage value.

> In May 1957, "based on these findings the District Judge made the following additional conclusions of law: (1) Allowable depreciation is determined in the light of conditions known to exist at the end of the tax year; (2) Depreciation deductions are to be corrected in any year when it is obvious that a fact involving useful life is in error; (3) Where the actual salvage value of assets is known at the end of a tax year, depreciation is not allowable for that year on such assets to the extent that their book value at the beginning of the tax year is less than their actual salvage value; . . ." (quoted from CA 6, 259 F. 2d 371).

In the appeal to the Sixth Circuit the taxpayer acquiesced to the original District Court ruling which called for a 10% salvage value, but allowed the useful life as computed by the taxpayer. The government did not appeal this interpretation of useful life. The Circuit Court stated that one of the ". . . well settled principles governing depreciation deductions" on which the two parties were in agreement was that "useful life is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income." This statement was made without supporting citations although the *Hertz* District Court decision had appeared some two months prior to this decision. Thus the appellate court addressed itself only to the question of salvage value. The Court upheld the District Judge's second finding and turned down the taxpayer's contention that salvage value should be estimated at the acquisition of the asset and not

changed later. The Court cited *Wier Long Leaf Lumber Co.* (9 TC 990; CA 5, 173 F. 2d 549) that "an adjustment to correct for mistaken salvage value is no different from an adjustment of a mistaken estimate of years of use." The court did state, however, that ". . . such a change in the salvage value would not affect prior taxable years."

Summary of Present Situation

It is apparent that these cases over the past two years have caused considerable confusion on the depreciation question. As indicated above, the Supreme Court has now agreed to rule on the *Hertz, Evans,* and *Massey Motors* cases. It is expected that the Supreme Court will concern itself with the meaning of "useful life" and "salvage value" and also with the question of the retroactive effect of the regulations. The final answer on these specific cases is not yet available. However, the strong undercurrent through all these cases is obvious; the Commissioner objects to a deduction of depreciation from ordinary income resulting in a later Section 1231 gain.

It is highly doubtful that even an adverse Supreme Court decision at this point will cause the Commissioner to abandon his stand. It seems quite likely that, either through court decisions or legislation, the combination of over-depreciation and Section 1231 gain will be effectively curtailed. In fact, accountants probably would not object to such curtailment if a method could be devised which would not work a hardship upon the taxpayer who has not abused the depreciation provisions and has a legitimate capital gains situation.

Looking to the Future

As indicated above, it appears that in planning for the future the taxpayer should not expect to depreciate assets on a very low basis and then have the gain on sale taxed at capital gain rates. One related area that may now require re-evaluation in light of a changed depreciation policy is that of leasing versus purchasing of equipment.

Not too many years ago the lease arrangement was possible only with automotive equipment and a few types of office equipment. Today it seems that almost everything from the pictures on the wall to the carpet on the floor can be leased. In the past it has been very difficult to demonstrate conclusively that either lease or purchase possessed definite tax advantages. It is very likely that this will continue to be true. The major factors in the decision to lease will probably still be the non-tax factors; however, as in the past, the tax aspects of each proposed transaction should be examined closely.

Two hypothetical cases, one of a short-lived asset and one of a longer lived asset, should illustrate the type of analysis needed, and also show that a revised depreciation policy may change the tax results of such an analysis.

In all the calculations below it is assumed that the assets were acquired in the first month of the year in order to omit any complications of partial year depreciation. Also, the factor of imputed interest has been omitted in order to keep the illustrations as simple as possible. The purpose of these cases is not to weigh the overall advantages and disadvantages of leasing, but simply to show how the new

AUTOMOBILE

Cost—$3,000

Former depreciation practice—4 year life, no salvage value.

New depreciation practice—2 year life, salvage value $1,200.

Lease Cost—$90 per month (This was quoted as a reasonable lease cost excluding all insurance and maintenance costs which, for this comparison will be assumed to be the same whether the asset is leased or owned.)

	Former Practice (declining-balance method)	New Practice (straight-line method)
Depreciation deduction:		
Year 1	$ 1,500	$ 900
2	750	900
	$ 2,250	$ 1,800
Tax savings therefrom (52%)	$ 1,170	$ 936
Sale price	$ 1,200	$ 1,200
Adjusted basis	750	1,200
Section 1231 gain	450	0
Tax thereon (25%)	113	
Net cash proceeds (sale price less tax)	$ 1,087	$ 1,200
Net cost to taxpayer:		
Purchase price	$3,000	$ 3,000
Less: net proceeds of sale	1,087	1,200
Net cash outlay	1,913	1,800
Less: tax savings from depreciation deduction	1,170	936
Net Cost	$ 743	$ 864

LEASING

Lease payments:	
($1,080 per year—2 years)	$ 2,160
Less tax savings therefrom	1,124
Net cost to taxpayer	$ 1,036

depreciation methods may affect the cost analysis.[1]

These two, somewhat abbreviated, examples both show that the change in depreciation policy can bring the net cost of owning up to a point where leasing becomes financially more attractive. Another very important factor in the whole problem is the timing of the cash outlay and the related interest cost. Particularly in long-lived assets, the year by year cash requirement should be studied. As indicated above, this element has been omitted from the above examples because it is not materially affected by the change in depreciation methods.

It is apparent that different tax brackets, useful lives, and lease arrangements can cause very different results. Where the asset is used for its full physical life and is disposed of for scrap value, the Commissioner's new position on depreciation will make little, if any, difference in the total cost of owning the asset. However, in any prospective leasing situation some type of comparative analysis should be considered together with the many other important factors necessary in making the final decision.

[1] For an excellent appraisal of the many arguments for and against leasing, see Donald R. Gant, "Illusion in Lease Financing," *Harvard Business Review*, March-April, 1959.

SHOP EQUIPMENT

Cost—$10,000
Former depreciation practice—10 year life; no salvage value
New depreciation practice—6 year life; $3,500 salvage value
Lease Cost—$100 per month

	Former Practice	New Practice
Depreciation deductions:		
Year 1	$ 2,000	$ 2,000
2	1,600	1,600
3	1,280	1,280
4	1,025	1,025
5	820	595[a]
6	655	0
	$ 7,380	$ 6,500
Tax Saxings therefrom (52%)	3,840	3,380
Sale price of the asset	3,500	3,500
Adjusted basis	2,620	3,500
Section 1231 gain	880	0
Tax thereon (25%)	220	
Net cash proceeds (sale price less tax)	$ 3,280	$ 3,500
Net cost to taxpayer:		
Purchase price	$10,000	$10,000
Less: Net proceeds of sale	3,280	3,500
Net cash outlay	$ 6,720	$ 6,500
Less: Tax savings from depreciation deduction	3,840	3,380
Net Cost	$ 2,880	$ 3,120

	Lease Cost
Lease payments:	
$1,200 per year—6 years	$7,200
Less: tax savings (52%)	3,744
Net cost to taxpayer	$3,456

[a] Maximum provision permitted is $6,500 under the Commissioner's new position that declining-balance depreciation may not be claimed below the expected salvage value.

Effect Upon Lessor

An important, but quite intangible, consideration in this whole problem is the effect such new depreciation practices may have upon the lessor. This effect will be particularly noticeable in the short-lived assets. If the automobile leasing companies are not permitted to use the declining-balance method and the Section 1231 gain, it is quite likely that they will have to increase their rates. They would experience the same increase in cost of owning the cars illustrated above, which really is the increase in taxes they will have to pay. To the extent that this increase can be transferred through higher lease rates the lessee will be faced with the unhappy choice of higher costs of owning or higher costs of leasing.

Present and Future Educational and Experience Requirements for Certified Public Accountants in Illinois

By Neil E. Clifton

In 1903 the Illinois legislature en-cted the first law in the United States equiring high school graduation as prerequisite for the certified public ccountant certificate. In 1943 the law as amended to further require, by 950, 30 semester hours of additional tudy in schools acceptable to the Uni-ersity of Illinois; the University was harged with the responsibility of ad-ninistration of the examination and he award of the certificates.

In 1957 the Illinois Accountancy ct was amended to provide, by 1967, or 120 semester hours of education bove the high school level. The in-rease from 30 to 120 hours is by 30-our steps, each three years, beginning 1 1961.

The development of the educational equirements of the Illinois law have hus been gradual and orderly. In onsideration of the effective date of ach change, the educational require-ents have been reasonable and seem ttainable to anyone with a sincere desire to take the examination. The objective of 120 semester hours, effective January 1, 1967, approaches, though it does not fully equal, the requirement of some states for the college degree as a requirement for the examination.

Present Requirements in Illinois

In order to be admitted to the C.P.A. examination in Illinois, the candidate must:

1. Be a citizen of the United States, or a person who has declared his intention of becoming a citizen,
2. Be a resident of Illinois, or with a regular place of business as a professional accountant in the State,
3. Be over 21 years of age, and of good moral character,
4. Be a high school graduate, or have completed an acceptable equivalent course of study, and
5. Successfully complete in colleges or schools acceptable to the University, prior to the date of filing the initial application;
   a. Before January 1, 1961—30 semester

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hours of accounting, business law, economics, and finance, of which at least 20 hours shall be accounting and auditing;

b. Between January 1, 1961 and January 1, 1964—60 semester hours in the same or additional subjects, of which at least 21 hours shall be accounting and auditing;

c. Between January 1, 1964 and January 1, 1967—90 semester hours in the same or additional subjects, of which at least 24 hours shall be accounting, auditing, and business law, provided that not more than 3 of the 24 hours shall be business law; and

d. After January 1, 1967—120 semester hours in the same or additional subjects, of which at least 27 hours shall be accounting, auditing, and business law, provided that not more than 6 of the 27 hours shall be business law.

It should be noted that the 1957 law does not, even after January 1, 1967, require a college degree. While the requirement of 120 semester hours approximates the semester-hour requirements of most colleges and universities for a baccalaureate degree, no requirement other than that of 27 semester hours in the specific fields has been imposed. The schools presumably include correspondence schools, schools which specialize in business training, and general colleges and universities, as in the past, provided they meet academic standards sufficient to satisfy the University of Illinois.

It should also be observed that once the applicant has met the educational requirements and filed application with the University to take the examination, he is not required to meet later increased educational requirements even should he initially be unsuccessful in passing the examination. (Whether the applicant must actually have taken the examination to avoid meeting later increased requirement is not stated.)

Illinois, as all other states, uses th uniform C.P.A. examination of th American Institute of Certified Publi Accountants. The examination is ad ministered by the Committee on Ac countancy of the University of Illi nois. Illinois, again as most othe states, is presently employing th grading services of the American In stitute of Certified Public Account ants, on an advisory basis. Th examination is divided into four parts accounting practice, theory of ac counts, auditing, and commercial law In Illinois separate grades are give the candidate for accounting (theor and practice, a weighted average) for auditing, and for commercial law The passing grade in each area is 7 of a possible 100.

Candidates who "condition" a par of the examination are permitted t take that portion of the examinatio again without rewriting the entir examination. The candidate has thre chances out of the next six examina tions (three years, examinations re peated semi-annually, May and No vember) to remove the conditio Should the candidate fail to remov the condition within the three-yea time limit, or should he fail the entir examination initially, he must wai one full year to re-apply, and mus first present evidence of completin additional preparation for the exam ination.

Under present rules of the Commit tee on Accountancy, to attain "condi tion" status, the candidate must:

1. Pass accounting (theory and practice and attain grades of not less than 5 in auditing and law; or
2. Pass auditing and law, and attain grade of not less than 60 in accoun ing; or

3. Pass accounting and either auditing or law, regardless of grade achieved in the subject not passed.

The Committee is authorized by ιw to charge a fee of not more than 50.00 for the examination and issuınce of the CPA certificate. At presıt, lesser amounts are being charged ersons taking parts of the examinaion for the purpose of eliminating a condition'' grade in a specific subect or subjects.

xperience Requirements, and Registration to Practice

To practice public accounting in llinois, a ''certified public accountnt'' must register with the Departıent of Registration and Education s a ''public accountant.'' Registraion may be obtained by the successul examination candidate when he as also satisfied the experience reuirements of the law, which requires rom one to three years practical exerience in the employ of a licensed ublic accountant. This experience ıay be obtained either before or after he candidate passes the examination.

The Department is authorized by aw to accept successful completion of wo years' study in a college or uniersity in lieu of one year of experince, and successful completion of a egular four-year course of study in ieu of two of the three years' required xperience.

The experience requirements were dded to the Illinois law in 1943 and ere not changed by the 1957 Act.

ature of the CPA Certificate in Illinois

Illinois is somewhat unusual among he 50 states of the United States beause its CPA certificate is in the naure of a degree awarded by the University of Illinois upon meeting the specific requirements and successful completion of the examination (Utah has similar provisions). The certificate does not, in itself, entitle the holder to practice public accounting. No experience is required to take the examination. Experience in public accounting is required to obtain registration with the Department of Registration and Education as a ''public accountant,'' and since 1943, only holders of C.P.A. certificates may qualify. Thus, to become a ''public accountant'' in Illinois, one must become a ''certified public accountant.''

What of the Future?

In 1956 the Commission on Standards of Education and Experience for Certified Public Accountants made various recommendations, some of them relatively long-range, for the preparation of individuals for public practice as CPAs and the accreditation of those individuals as CPAs. This Commission was composed of 24 individuals, from both the fields of public practice and of education, and included members of numerous state organizations of CPAs, the American Institute of Certified Public Accountants, the American Accounting Association, the Association of CPA Examiners, and the American Association of Collegiate Schools of Business. Among the recommendations of the Commission were:

1. The requirement of completion of a college program leading to the baccalaureate degree, including a substantial amount of general and cultural courses, as a necessary preliminary to further training for public accountancy as a CPA. The equivalent of an accounting major would be a requirement of this degree.
2. The requirement of completion of an additional professional academic train-

ing program of not less than twelve months pointed directly toward specialized training in public accountancy.

3. That the CPA examination be given at the conclusion of formal training and that both the compilation and the grading of the examination be pointed solely towards testing the results of the academic program.

With this background together with the other recommendations and future development envisioned by the Commission, the members stated the belief "that the CPA certificate may eventually come to be interpreted uniformly as a mark of competence, obtained through the formal educational process, to enter the profession of public accountancy as a CPA."

As a transitional goal, the Commission recommended the requirement of:

1. College graduation, including completion of an accounting major,
2. Satisfactory completion of the uniform CPA examination,
3. A minimum of two years of practical experience in public accountancy under the guidance of a CPA.

Certainly if the certified public accountant is to be recognized as a professional, a man specialized and competent in his field, the requirement of a college degree should be an objective in Illinois not later than 1970. (Some states, in fact, now require a college degree for the examination, so we will be far from the forefront in setting up such a standard.) Professional academic training beyond the college degree is certainly a desirable, if not a practical requirement. The CPA will, to an increasing degree, be dealing with college graduates in practically all lines of business, and certainly his education, both formal and acquired after graduation, must equal that of the persons he serves.

It is hoped that there will never be an experience requirement in Illinois as a prerequisite to taking the CPA examination or any part of it. If an applicant can pass an examination that is necessarily and *properly* theoretical, he should not be denied the opportunity. On the other hand, many accountants, including some members of the Commission on Standards, believe that the CPA certificate should be more than a stamp of approval of one qualified to enter the field of public accounting. These persons, and I include myself, would require experience in the specific field of public accounting, whether before or after passing the CPA examination, before the CPA certificate is awarded.

In general, Illinois appears to have a good public accounting law at present. Over a period of time, the educational requirements should be raised to conform with the general objectives outlined by the Commission on Standards. It is to be hoped that the confusion of terms, "public accountant" and "certified public accountant," mentioned in the preceding section may eventually be eliminated. Perhaps this can be accomplished by withholding the awarding of the CPA certificate until the experience requirements have been met. If the Department of Registration and Education of the State of Illinois is to register persons entitled to practice in the state (in our profession as in other professions), perhaps the University of Illinois should also be charged with the responsibility for approval of the individual's experience and certification to the Department of individuals who have both passed the examination and met the experience requirement of the law.

The awarding of the CPA certificate would thus become synonymous

vith the right to practice public ac- ounting in the State of Illinois. The enefits of regulation by the state vould be merged with the benefits of ecognition by the public of an in- lividual fully qualified to serve the ublic by background of training both ormal and practical.

The further development of the Illinois Accountancy Act as related to the long-range recommendations of the leaders of the profession, will indeed be of interest to certified public accountants. Indeed, the development of the practice of public accounting itself, is of vital interest to those in practice and the public they serve.

INVENTORY OBSERVATION

By O. Eldred Gough

The auditing of inventories generally presents a greater challenge to the independent accountant than any other balance sheet item. Therefore, any CPA who treats lightly his responsibility in the area of inventory observation is flirting with danger. Such a practice might well result in the loss of both professional reputation and personal fortune. Because of the great diversity in the physical makeup of the components, and the varying degrees of inventory control, it is imperative that the auditor exercise all of the skill, ingenuity, and all-around professional judgment at his command in the verification of inventories, particularly as to quantities.

Bankers and other credit grantors tell us that the cases coming to their attention involving violations of generally accepted auditing procedures are more prevalent in the areas of inventory observation and confirmation of accounts receivable than any other. A serious error that can place the CPA in the bankers' "dog-house" is the release of a long-form report in which the CPA renders an unqualified opinion and then explains in the comments section of the report that inventories were not observed and accounts receivable were not confirmed. Bankers state that they still are receiving such reports.

Because inventories are often a very material item in balance sheets and do have a material effect on the determination of cost of sales, and because of the disclosed lethargy by some accountants in the audit of inventories, it seems a good time to review the subject of inventory observation. In doing so, it will be considered in three phases: (1) Minimum requirements as set forth in pronouncements by the American Institute of Certified Public Accountants; (2) Important auditing procedures necessary to satisfy these requirements; and (3) Review of some specific inventory situations.

Obviously, it is not possible to go into detail in each phase. Therefore, consideration is limited to those points generally considered most important, together with those that may be applicable in special situations.

(1) Minimum Requirements as Set Forth in Pronouncements by the American Institute of Certified Public Accountants—

At the 1939 annual meeting, the membership of the American Institute approved the "extension of auditing procedures," one extension of which was the requirement for the observation of inventories. Failure to apply such a procedure, where practicable and reasonable, in general, precludes the expression of an opinion on the fairness of the financial statements taken as a whole. The procedure, inventory observation, must be both practicable and reasonable. In the province of auditing, practicable means "capable of being done with available means"—or—"with

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eason or prudence''; reasonable neans "sensible in light of the surounding circumstances."

A close analysis of this extension of uditing procedure leads to the conlusion that it includes nearly all f the inventory audit situations enountered; there are very few cases vhere it is not practicable and reasonble to observe the taking of physical nventories. Among the cases where t is not practicable and reasonable are he following:

A. Where the auditor has been engaged to examine the financial statements after the physical inventory has been taken. In such cases, assuming that the beginning inventories had been observed by reputable CPAs, an alternative procedure at the year end might be physical tests made subsequently, and this procedure might be a satisfactory substitute for observation of the inventory-taking. He may also examine written procedures prescribed for the inventory-taking, review the original tags or sheets, and make suitable tests of the compilation.

B. In times of emergency, Government requirements may prohibit shutdown and interruption of production for inventory purposes. When, for this or any other reason, work-in-process inventory can not be taken in the customary way, the auditor must exercise his ingenuity to find a reasonable substitute. Quantity records maintained for labor bonus purposes may be priced and extended and the total compared with the control account; records of finished production may be examined after the inventory date to determine quantities produced. Such procedures may offer a satisfactory basis for an opinion.

In these unusual situations where he extended procedures are not used nd alternative procedures can be mployed which will enable the CPA o express an opinion, he should, if he inventories are material in amount, lisclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph to such omission. In deciding upon the alternative procedures to be employed, the CPA must keep in mind that he assumes responsibility for the opinion expressed.

(2) Important Auditing Procedures Necessary to Satisfy These Requirements—

The ideal time for taking the inventory is the end of the reporting year. As a practical matter, however, if this were the case with all clients, it would be virtually impossible for the accountants to cover all of the engagements. Fortunately, many companies have adopted the practice of taking inventories at some date other than the year end. Others have a continuous program of taking physical inventories throughout the year, covering all items at least once a year. These practices may be acceptable to the independent accountant if the company records are maintained so that he can perform additional tests necessary to satisfy himself that the inventory is fairly stated at the balance sheet date. The same observation procedures will be generally applicable regardless of the inventory taking program used by the client.

The primary objective in the observation is to ascertain that the inventory is fairly stated. This objective may be achieved by determining that the methods employed in the physical count produce an accurate inventory.

The best way for the auditor to satisfy himself in this respect is to observe the inventory teams at work to see that the instructions for taking the inventory are being carefully followed. It is always desirable to have

prepared a set of inventory instructions well in advance of the physical count. The teams should become familiar with them. The instructions should include provision for:

A. Control over inventory tags.

B. Having tags attached to all materials, together with full description of items and stages of completion for work in process.

C. Two countings of material noted on each tag, and in the event of differences, provide for a third counting. In certain cases it may be acceptable to have only one complete counting crew and one crew to follow and count sections on a test basis.

D. Assurance that obsolete, spoiled, scrapped, or slow-moving materials are inventoried, and that the tag is correctly marked.

E. Upon completion of the count, an inspection by responsible individuals to ascertain that each section has been counted. They will then detach the tags and account for all tags used.

The auditor should assist in the planning of the inventory procedures and several days before the actual physical counting begins, he should inspect the premises to see that the physical arrangement is such that a good count is both possible and probable. If the arrangement is extremely poor, he should request that the stock be rearranged.

In order to satisfy himself of the effectiveness of the inventory count, the auditor should make the following observations or tests:

A. *Identification and Description.* The auditor should inspect some items of stock, determine the source of description, see that proper differentiation is made for the various stages of work in process, and check his findings with production personnel. Conflicting answers to his questions may cause doubt whether the client's employees taking the inventory are actually familiar with it.

B. *Segregation or Notation of Slow-Moving, Obsolete, or Damaged Goods.* Frequently such items can be recognized by the auditor, or personal inquiry together with a review of perpetual records may reveal their existence.

C. *Control of Tags or Sheets.* The auditor should determine that each inventory team is responsible for a sequence of prenumbered tags and that each team must return those unused or spoiled. He should determine that an employee accounts for all tags at the completion of the inventory. He should observe that all items have been properly tagged or marked to avoid duplication or omissions.

D. *Practices in Verifying Individual Counts.* The auditor should observe some of the counts, noting that quantities and descriptions are accurately recorded on the tags of inventory sheets. The auditor himself will normally make a certain number of test counts, including some items of substantial value; in the event that differences between the limited test counts which the auditor makes and the counts by client's employees, the auditor may insist upon recounts of the entire section in which the unsatisfactory condition exists.

If inventory sheets are used instead of tags, he should select some items from the sheets to count on the floor, and also trace some items on the floor to the inventory sheets.

Random tests should be made of the contents of the packages. It is not reasonable to expect that many original cartons or packages be broken open or that an unreasonable amount of inspection be made of items not easily accessible, but when the auditor suspects that the inventory is not well taken, he should take all steps which he believes necessary to allow an accurate count.

E. *Practices in Obtaining Proper Cutoff.* At the time of the inventory, the auditor should visit the receiving and shipping departments, noting the last receiving and shipping document numbers, and ascertaining that each department has been informed that no receipts after and no shipments before the cutoff should be included in inventory. It is frequently desirable for receiving and shipping departments to earmark materials which should not be

included in the inventory. The auditor can usually make a check of the records of these departments after the inventory count, and compare the receiving and shipping cut-off numbers to accounting department records.

Manufacturing operations should be suspended for the physical inventory; if they are not, unusual care must be taken to control the movement of inventory.

The need for complete working papers of the observation of inventories cannot be over-emphasized. Anyone who reviews the working papers at a later date should be able to determine exactly what was done.

The auditor should note counts of certain items and other data to be checked later when he receives the finished inventory records. He may request and retain control of duplicate inventory stubs or sheets which he should compare to the physical inventory records. If he does not receive duplicate count records, he may note items from the original counts to be checked to inventory summaries.

In his review of internal control, the auditor should determine the procedures used to inventory goods on the premises belonging to others, such as consignments-in, bailments, goods on approval, and goods held for repair; while the physical inventory is being taken, the auditor should be satisfied that these items are properly identified, that employees are aware of the nature of the items, and that they are recorded as the property of others. The auditor can later make such tests of accounting or other records needed to give him assurance that the property of others is properly recorded.

(3) REVIEW OF SOME SPECIFIC INVENTORY SITUATIONS—

A. Materials stored in piles (scrap iron, iron ore, coal, etc.)

1. Problems:
   (a) The ground on which the pile rests may not be level;
   (b) The material may include both heavy and light metal, making it impracticable to use a common measure of weight per unit of volume; of volume;
   (c) The extent to which the pile has sunk into the ground may not be determinable; or
   (d) The density of the pile may not be uniform because a variety of shapes has caused uneven packing.
2. Special Tests:
   While physical tests of quantities by the independent auditor would not be practicable and reasonable in such circumstances, there may be other factors which can guide him to either accept or decline the representations of his client.
   (a) One such factor is the method of handling and account ing for piles. If withdrawal from a pile has started but no additions have been made, each pile in turn should be completely liquidated before starting another, thus allowing a check upon the accuracy of its contents.
   (b) If this method is not used, the auditor may wish to employ professional appraisers.

B. Inventories of packaged materials (barrels, boxes, or bags) stacked in solid formation.

1. One of the dangers in these situations is the presence of a ''hollow square.'' To detect this, the auditor should climb to the top of the packaged materials and inspect the stack from above.
2. He may also want to have some packages broken to verify the the contents.
3. A special case of a paint factory is known; the auditor observed the count of one large section of five gallon cans supposedly filled with paint. The cans were stacked quite high and he asked

to be lifted by one of the lift trucks in order that he might see that there was no "hollow square." When he stepped on top of the stack, it almost toppled down because the paint cans were empty.

The auditor should "sound out" packages selected at random to determine that empty containers are not being inventoried.

C. Inventory stored in bins tanks, grain elevators, etc.

1. Dangers:
   - (a) False bottoms or unfilled sections.
   - (b) Containing merchandise of less value than represented.

2. Additional tests to guard against these dangers:
   - (a) Sound out the bin or tank by hitting it with a hammer at various heights. Such a procedure should reveal hollow spaces, unless the bin is made of concrete.
   - (b) With a light, look down in the bin or tank to see that the merchandise is as represented.
   - (c) Draw some of the contents from the hoppers, taps, or spouts to determine that they are as represented.
   - (d) Measure from top of storage facility down to the the contents at various points, then compute the volume content.

A situation is known where the auditor observed an inventory involving four different petroleum by-products stored in large tanks. In this case, some of the by-products were more valuable than others and the auditor was not able to tell the difference by inspection. So he drew samples of each of the by-products and numbered the bottles. The auditor, being the only one knowing which sample came from the respective tanks, then took them to the client's laboratory located in another city and had them analyzed. By this procedure, the auditor was able to determine that the contents of the tanks were as represented.

Conclusion

To summarize, it is necessary for an auditor to consider all conditions surrounding the physical inventory count to determine if it is possible or reasonable to perform sufficient procedures to enable him to render an unqualified opinion. If such an opinion is possible, then carefully planned programs must be drafted, including all steps from the initial instructions to inventory teams to the verification of the final inventory summary. One should always be careful not to stretch his rationalizations to such a point that unqualified opinions are rendered based on extended procedures of less than the established requirements. To do so is to take unwarranted personal risk and delay the time of complete public acceptance of the accounting profession.